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No. 04-1264

IN THE

Supreme Court of the United States

BUCKEYE CHECK CASHING, INC.,
Petitioner,

v.

JOHN CARDEGNA AND DONNA REUTER,
Respondents.

On Writ of Certiorari
to the Supreme Court of Florida

BRIEF OF AMICUS CURIAE THEIS RESEARCH, INC., IN SUPPORT OF NO PARTY ON THE MERITS

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INTRODUCTION

Congress never intended the Federal Arbitration Act to be a Trojan horse to assault the citadel of police powers vested in the states. The FAA is not a general federal license—and enforcement mechanism—for private parties to contract in violation of state law. The FAA does not authorize unlawful conduct, even if one enlists an arbitrator as an accessory after the fact.

The FAA does not authorize courts to confirm arbitration awards that derive from unlawful contracts. Instead, 9 U.S.C. § 2 requires that courts uphold and enforce law applicable to contracts generally, and 9 U.S.C. § 10 requires that courts vacate awards issued by arbitrators who act without power conferred by a valid contract.

INTERESTS OF THE AMICUS CURIAE[1]

Amicus curiae Theis Research, Inc. (Theis, pronounced "Tice") is the petitioner in *Theis Research, Inc. v. Brown & Bain*, No. 04-1566. The petition for a writ of certiorari in that case is pending before the Court as of the submission of this brief.

The law firm of Brown & Bain (B&B, respondent in No. 04-1566) previously represented Theis in patent litigation that went awry. The representation primarily

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[1] This brief is submitted pursuant to the general consent to the filing of amicus briefs, filed by each party on August 1, 2005. This brief has not been authored, in whole or in part, by counsel for a party in this case (No. 04-1264). No monetary contribution to its preparation or submission has been made by any person or entity other than Theis Research, Inc., its counsel, and Success at Last LLC, a non-equity investor in Theis.

involved litigation in the Northern District of California. B&B's legal services agreement provided that it was governed by California law.

To comply with an arbitration clause in B&B's legal services agreement, Theis arbitrated its malpractice claims against B&B. The arbitrator's award gave nothing to either side. Theis thereafter discovered that B&B had violated state conflict-of-interest law because it had simultaneously represented the integrated subsidiary of an adverse party in the patent litigation. By undertaking to represent Theis, B&B had violated California law.[2]

Theis filed a diversity action in the United States District Court for the Northern District of California, seeking to vacate the arbitration award. Theis relied on California law holding unlawful contracts void *ab initio* and nullifying embedded arbitration clauses and resulting awards. Theis cited additional conflicts disclosed in discovery. The district court nevertheless confirmed the arbitration award and held that Theis' conflict of interest claims were barred by claim preclusion doctrine. On appeal, the Ninth Circuit affirmed.

The issues presented by Theis' petition for a writ of certiorari include the following related questions:

- Whether courts—as opposed to arbitrators—shall decide challenges to an underlying agreement with an arbitration clause on the ground that the agreement was void and never existed at the outset, in contrast to agreements that are merely voidable.

[2] B&B concurrently violated a district court rule incorporating the California Rules of Professional Conduct. *See* U.S. District Court, N.D. Cal., Civil Local Rule 11-4.

- Whether, in a diversity case, state law can render an unlawful underlying agreement, including an arbitration clause and a resulting arbitration award, null and void *ab initio*.

Because the Court has determined that the Federal Arbitration Act applies to state court proceedings (*Southland Corp. v. Keating*, 465 U.S. 1, 12 (1984)), the rule applicable to diversity cases would also govern state court cases, such as the present case.

Theis generally supports the position of respondents in this case.

However, Theis also raises considerations that do not appear to advance respondents' position. Theis discusses below the approach that has been taken by the California courts, which distinguishes unlawfulness of the underlying contract as a whole versus unlawfulness of a single, severable provision.

In *Theis Research, Inc. v. Brown & Bain*, where B&B's attempted formation of a legal services agreement with Theis was unlawful *per se*, the illegality applies to the purported contract as a whole. In such circumstances, the California courts have held that the entire agreement—including any arbitration clause—is void *ab initio*.[3] Because there was never any valid underlying agreement, there is no effective arbitration clause, and no authority is contractually conferred on an arbitrator. Without authority, any determination by an arbitrator is a nullity, and any arbitration award must be vacated.

[3] California authorities refer interchangeably to illegality and unlawfulness.

On the other hand, the California courts have held that illegality of a single provision, if severable, does not void a remaining lawful agreement. In that instance, the arbitration clause survives with the remainder of the contract; the parties' dispute is arbitrable; and even the illegality challenge to the single provision must be presented to the arbitrator—at least in the first instance.

Theis also addresses the role of courts in ruling on questions of illegality on post-arbitration review. The instant case comes before the Court pre-arbitration. The trial court denied petitioner's motion to compel arbitration and to stay judicial proceedings. Nevertheless, as discussed below, petitioner noted in its brief to the Florida Supreme Court the role of courts in addressing illegality in proceedings to enforce an arbitrator's award.

Theis has argued in support of its petition for a writ of certiorari that plenary review of *Theis Research, Inc. v. Brown & Bain* should be joined with consideration of this case to frame the complete picture of the matter at issue. Pending the Court's consideration of that request, Theis respectfully offers the arguments set forth below.

STATUTES INVOLVED

9 U.S.C. § 2. *Validity, irrevocability, and enforcement of agreements to arbitrate*

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 3. *Stay of proceedings where issue therein referable to arbitration*

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

9 U.S.C. § 4. *Failure to arbitrate under agreement; petition to United States court having jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination*

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. . . . The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. . . . If the making of the arbitration agreement . . . be in issue, the court shall proceed summarily to the trial thereof. . . . Where such an issue is raised, the party alleged to be in default may, except in cases of admiralty, . . . demand a jury trial of such issue, ...

9 U.S.C. § 9. *Award of arbitrators; confirmation; jurisdiction; procedure*

If the parties in their agreement have agreed that a judgment of the court shall be entered upon the award made pursuant to the arbitration, . . . any party to the arbitration may apply to the court so specified for an order confirming the award, and thereupon the court must grant such an order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title. . . .

9 U.S.C. § 10. *Same; vacation; grounds; rehearing*

(a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—

(1) where the award was procured by corruption, fraud, or undue means;

* * *

(4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

* * *

SUMMARY OF ARGUMENT

Under the Federal Arbitration Act (FAA), the authority of an arbitrator pursuant to an arbitration clause embedded in a contract is premised on the validity of the underlying contract under state law applicable to contracts generally. There is no basis for submitting a matter to an arbitrator if illegality rendered the underlying contract void *ab initio*.

Accordingly, whether the underlying agreement is valid or void *ab initio* is a gateway issue that must be decided by a court. The fraud-in-the-inducement rule of *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395 (1967), does not require a different result. That rule

presupposes the existence of a valid agreement, subject only to voidability and subsequent rescission at the option of a defrauded party.

While a court must determine a challenge based on unlawfulness that pertains to the underlying agreement as a whole, an illegality challenge could be submitted to an arbitrator in the first instance if it only concerns a single, severable provision and would not have the effect of voiding the remainder of the underlying contract (which includes the surviving arbitration clause).

Particularly on post-arbitration review, courts must decide illegality challenges if the FAA is not to be transmuted into a tool for the judicial enforcement of private contracts entered into in violation of generally applicable state law.

ARGUMENT

I. An underlying contract valid under state law is a precondition for an embedded arbitration clause to be effective under the Federal Arbitration Act

It takes a valid contract to have a valid contract with an arbitration clause.

The Federal Arbitration Act (FAA) conditions the effectiveness of an arbitration clause on compliance with law applicable to contracts generally. At 9 U.S.C. § 2, the FAA provides that an arbitration clause

> shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

State-law contract rules govern the validity of arbitration agreements. Although Congress enacted the FAA pre-*Erie*, the Court has effectuated principles of federalism in the application of § 2.

> When deciding whether the parties agreed to arbitrate a certain matter . . ., courts generally . . . should apply ordinary state-law principles that govern the formation of contracts.

First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 944 (1995).

In *Prima Paint*, the Court noted that when enacting the FAA, Congress intended "to make arbitration agreements as enforceable as other contracts, but not more so." 388 U.S. at 404 n.12.

Interpreting § 2, the Court has applied this neutrality test in determining whether state law renders a purported arbitration clause invalid.

> States may regulate contracts, including arbitration clauses, under general contract law principles and they may invalidate an arbitration clause "upon such grounds as exist at law or in equity for the revocation of *any* contract." 9 U.S.C. § 2 (emphasis added).

Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 281 (1995); *accord Doctor's Associates v. Casarotto*, 517 U.S. 681, 686-687 (1996).

Under the FAA, the application by courts of "ordinary state-law principles that govern the formation of contracts"

pertains to the validity of contracts containing embedded arbitration clauses.

With respect to "a contract evidencing a transaction involving commerce," the power of an arbitrator depends upon "[a] written provision in . . . a contract . . . to settle by arbitration a controversy thereafter arising out of such contract . . ., or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, ..." 9 U.S.C. § 2. Thus, § 2 speaks of both (a) an arbitration clause embedded in "a contract" and (b) an agreement created to arbitrate an existing controversy arising out of "a contract."

With respect to an embedded arbitration clause, § 2 necessarily requires "a contract" and that the contract be valid under law applicable to "any contract."

The first three times the term "contract" appears in § 2, it refers to an underlying agreement. There is no suggestion that when the term appears for the fourth time—conditioning validity on compliance with law applicable to "any contract"—such compliance with law is not required for the underlying agreement.

To premise an agreement to arbitrate on an arbitration clause embedded in an underlying contract, there must be an underlying agreement. Thus, the existence of a valid embedded arbitration clause depends on the existence of a valid underlying contract. A court cannot find an embedded arbitration clause effective under the FAA without finding the existence of an underlying contract valid under law applicable to "any contract."[4]

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[4] Indeed, it would have made no sense for Congress to have singled out underlying contracts, of all things, to have their

The language in the general provisions of the FAA (Chapter 1) indicates that the sections are to be read and understood in sequence. The sections that follow § 2 do not repeat the language of both (a) an arbitration clause embedded in "a contract" and (b) an agreement created to arbitrate an existing controversy arising out of "a contract."

Nevertheless, *both* of these are included when, for example:

- § 3 refers to "an agreement in writing for such arbitration" in the course of providing for a stay of judicial proceedings;

- § 4 refers to "a written agreement for arbitration" in prescribing means to compel arbitration;

- § 4 prescribes the judicial proceeding to adjudicate "the making of the arbitration agreement";

- § 9 refers to the parties' "agreement" in the course of providing for confirmation of an award (which section is in turn subject to the vacatur and modification provisions in §§ 10-11).

Thus, the "agreement . . . for . . . arbitration" and "the making of the arbitration agreement" referenced in §§ 3-4 necessarily contemplate, with respect to an embedded arbitration clause, an underlying contract made in compliance with state law and valid under law applicable to "any contract."

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validity determined without reference to law applicable to "any contract."

If illegality under state law applicable to "any contract" renders a purported underlying contract null and void *ab initio*, there is no valid contract into which to embed an arbitration clause. Therefore, no such purported arbitration clause can be given effect under the FAA.

A contrary determination would invite cataclysmic results. It would invite violation of general state law by effectuating arbitration clauses embedded in purported contracts entered into illegally. Further, it would trigger a mechanism for judicially enforced submission to arbitrations and awards premised on unlawful contracts.

II. Courts, as opposed to arbitrators, should decide a challenge to an underlying agreement as null and void *ab initio* for illegality

In the absence of an agreement by the parties, there is no basis to confer authority on an arbitrator. Instead, the authority of an arbitrator pursuant to an embedded arbitration clause is conditioned on the existence of an underlying agreement valid under state law applicable to contracts generally. The existence of a lawful agreement is a gateway issue that must be decided by a court.

If an arbitrator rejects a challenge to an underlying agreement as void *ab initio* for illegality, there is no basis to defer to the arbitrator's decision. A court must still decide the issue, and if it determines the contract void *ab initio* for illegality, the court must vacate the arbitrator's decision as *ultra vires*.

On the other hand, an arbitrator's decision that an underlying agreement is indeed void *ab initio* for illegality simply presents a conundrum. The decision finds that the arbitrator lacked authority to make the decision.

Congress did not assign to arbitrators the responsibility to decide whether an underlying agreement (with an embedded arbitration clause) even exists in the first place. Indeed, under § 4 of the FAA, upon demand a jury shall decide disputed issues of fact concerning whether the parties made an agreement to arbitrate.

Illegality, in particular, is a proper subject for determination by courts. For a court to place its imprimatur on illegality by confirming an arbitration award arising from an unlawful contract is anathema. More fundamentally, because government sets the laws that limit the power of private parties to contract, whether a purported contract is unlawful must ultimately be determined by someone commissioned by the government to decide questions of legality—a judge.

In *First Options*, 514 U.S. at 944-945, this Court held regarding arbitrability that courts, rather than arbitrators, decide the scope of an arbitrator's authority under an arbitration clause—unless the parties have explicitly agreed to confer power on the arbitrator to decide arbitrability. Yet even the power of an arbitrator to decide the scope of a clause, when so empowered by such an explicit agreement, presupposes the existence of a valid underlying contract or agreement.

In *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003), this Court considered whether a court or an arbitrator should decide the availability of a class action under an arbitration clause. The Court did not consider the question foreclosed because arbitration awards had already been rendered. The plurality opinion found that such an issue should be remanded to the arbitrator, but it raised a distinction that should be applied in this case:

> In certain limited circumstances, courts assume that the parties intended courts, not arbitrators, to decide a particular arbitration-related matter . . . . They include certain gateway matters, such as whether the parties have a valid arbitration agreement at all . . ..

Id. at 452 (Breyer, J., joined by Scalia, J., Souter, J., Ginsburg, J.). Even as to the issue in *Green Tree*, the dissent of the Chief Justice (joined by O'Connor, J., Kennedy, J.) asserted that "this determination is one for the courts, not for the arbitrator, ..." *Id.* at 455.

A number of courts have distinguished between underlying contracts that are void *ab initio*—and therefore cannot confer any authority on an arbitrator—and underlying contracts that exist but are subject to voidability—permitting arbitrators to decide the matter in the first instance.

Applying the FAA, the California Supreme Court determined in *Rosenthal v. Great Western Financial Securities Corp.*, 14 Cal. 4th 394 (1996), that: "If the entire contract is void *ab initio* . . ., the parties have not agreed to arbitrate any controversy; . . .." *Id.* at 416.

In the case before it, the court distinguished between fraud in the execution of the underlying agreement and fraud in the inducement. Because fraud in the execution would render the contract void, it is to be determined by a court. *Id.* at 417. Fraud in the inducement, however, would not negate the existence of the contract, but would only render it voidable, permitting the defrauded party the election of rescinding or enforcing the contract. *Id.* at 415.

Accordingly, the California Supreme Court distinguished the rule set forth by this Court in *Prima*

Paint, that an arbitrator decides a defense of fraud in the inducement of a contract unless the fraud relates specifically to the arbitration clause itself and not to the contract generally. *Id.* at 416.

Several circuits have also held that courts—rather than arbitrators—are to decide issues as to whether an underlying contract even existed, or was null and void *ab initio*.

In *Three Valleys Mun. Water Dist. v. E.F. Hutton*, 925 F.2d 1136, 1140 (9th Cir. 1991), the Ninth Circuit previously held that courts, not arbitrators, decide issues that determine whether an underlying contract (with an arbitration clause) existed in the first place. *Id.* at 1140-1141. *Three Valleys* distinguished the rule in *Prima Paint*, explaining that *Prima Paint* only concerned an issue of "voidability"—not a challenge to whether a valid contract existed at the outset.

> . . . *Prima Paint* applies to "voidable" contracts—those "where one party was an infant, or where the contract was induced by fraud, mistake, or duress, or where breach of a warranty or other promise justifies the aggrieved party in putting an end to the contract." [Citation.] . . . . But, because an "arbitrator's jurisdiction is rooted in the agreement of the parties," [citations] a party who contests the making of a contract containing an arbitration provision cannot be compelled to arbitrate the threshold issue of the *existence* of an agreement to arbitrate. *Only a court can make that decision.*

925 F.2d at 1140-1141 (footnote omitted)(second emphasis added).

Other circuits have taken the *Three Valleys* approach. In *Sandvik AB v. Advent Int'l Corp.*, 220 F.3d 99 (3d Cir. 2000), the Third Circuit held:

> Mindful of the doctrine announced in *Prima Paint*, which did not consider a situation in which the existence of the underlying contract was at issue, we draw a distinction between contracts that are asserted to be "void" or non-existent, as is contended here, and those that are merely "voidable," as was the contract at issue in *Prima Paint*, for purposes of evaluating whether the making of an arbitration agreement is in dispute.

Id. at 107 (footnote omitted). Whether there is an agreement to arbitrate in turn depends on the validity of the underlying contract. *Id.* at 106.

Citing *Three Valleys* and *Sandvik*, in *Sphere Drake Ins. Ltd. v. Clarendon Nat'l Ins. Co.*, 263 F.3d 26, 31 (2d Cir. 2001), the Second Circuit also invoked "the distinction between void and voidable contracts, a distinction already recognized in at least two other circuits."

> A void contract is one that produces no legal obligation. . . . [A] party alleging that a contract is void—and providing some evidence in support—is entitled to a trial on the contract's arbitrability.

Id. at 31.[5]

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[5] Applying the FAA, the Supreme Court of Minnesota cited *Sphere Drake*, *Sandvik AB*, and *Three Valleys* in making the distinction that courts hear claims that a disputed contract is

In *Spahr v. Secco*, 330 F.3d 1266, 1272 n.7 (10th Cir. 2003), the Tenth Circuit acknowledged that:

> It is true that many circuits have applied *Prima Paint* to voidable contracts—i.e., those where the contract was induced by fraud, mistake, or duress—but not to void contracts.

The court proceeded to distinguish *Prima Paint* further, holding that even a question of voidability should be determined by the court—rather than the arbitrator—where the party objecting to arbitration asserted that the underlying agreement with the arbitration clause was unenforceable based on a lack of mental capacity to enter into the agreement in the first place. *Id.* at 1272-1273.

In *I.S. Joseph Co. v. Michigan Sugar Co.*, 803 F.2d 396 (8th Cir. 1986), the Eighth Circuit stated:

> Case law supports our holding that the enforceability of an arbitration clause is a question for the court when one party denies the existence of a contract with the other.

Id. at 400 (directing district court to disregard arbitrators' validity holding).

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void, while claims that a contract is *voidable* must be arbitrated. *Onvoy, Inc. v. SHAL, LLC*, 669 N.W.2d 344, 353 (Minn. 2003).

> [P]arties may not be compelled to arbitrate claims if they have alleged that the contract at issue never legally existed.

Id. at 354.

In *Microchip Tech. Inc. v. U.S. Philips Corp.*, 367 F.3d 1350, 1356-1358 (Fed. Cir. 2004), the Federal Circuit determined that whether the plaintiff was a successor to a license agreement, which contained an arbitration clause, was a "gateway" issue to be determined by a court. To determine whether an arbitration agreement exists, the existence of the entire agreement was a "threshold question" for the court. *Id.* at 1358.

Still other circuits, however, have taken a contrary approach, rejecting the "void" versus "voidable" distinction. *Will-Drill Res., Inc. v. Samson Res. Co.*, 352 F.3d 211, 215 n.15 (5th Cir. 2003). *Will-Drill* held that a court must determine whether a contract contained sufficient signatures to be valid and therefore binding on even admitted signatories. Attempting to distinguish Fifth Circuit precedent that an arbitrator determines whether illegality renders a contract void *ab initio*, the court conceded that:

> We are forced here to an admittedly fine distinction. And we do not doubt that this distinction will occasionally be elusive.

Id. at 219.

In *Burden v. Check into Cash of Kentucky, LLC*, 267 F.3d 483 (6th Cir. 2001), the Sixth Circuit reversed and remanded a district court decision that relied on *Three Valleys* in holding that the court must determine whether illegality rendered an underlying agreement void *ab initio*. Citing *Burden*, the Eleventh Circuit in *Bess v. Check Express*, 294 F.3d 1298, 1306 (11th Cir. 2002), held that an arbitrator should determine whether illegality rendered the substance of the underlying agreement void.

Burden was subsequently criticized in its circuit in a concurring opinion in *Match-E-Be-Nash-She-Wish Band of Pottawatomi Indians v. Kean-Argovitz Resorts*, 383 F.3d 512, 518-521 (6th Cir. 2004)(Cleland, D.J., sitting by designation, concurring):

> Void and void *ab initio* agreements, as opposed to voidable agreements, are agreements that never existed. Confining void (or void *ab initio*) contracts to a narrow set of circumstances, as the court did in *Burden*, abrogates long-standing principles defining void contracts and holds as of no effect any legislature's decision to deem certain agreements void when they fail to comply with statutory requirements, ...
>
> The Federal Arbitration Act's policy favoring arbitration cannot compel an agreement to arbitrate where no contract exists. *A void contract is simply nonexistent and a provision of a contract that does not exist should not be separately enforceable.* This includes an arbitration clause.

Id. at 520-521 (emphasis added).

Whether an underlying contract (with an embedded arbitration clause) is unlawful and therefore void *ab initio* is an issue that must be decided by a court.

III. Prima Paint does not require a different result

As referenced above, this Court set forth in *Prima Paint* a rule that an arbitrator decides a defense of fraud in the inducement of a contract unless the fraud relates specifically to the arbitration clause itself and not to the contract generally. 388 U.S. at 402-404.

The effect of such a claim is structurally different from the result of a challenge to an underlying contract as void *ab initio* for illegality. As explained by decisions discussed above, a claim of fraud in the inducement does not challenge the existence of an underlying contract as void *ab initio*, but rather it seeks to hold an extant contract voidable at the option of the defrauded party.

The *Prima Paint* rule serves the practical purpose of having closed a potential loophole that could have let a party avoid arbitration of a contractual dispute despite having entered into a valid agreement with an arbitration clause. If not for the rule, a party claiming breach of a contract (that contains an arbitration clause) could claim fraud in the inducement and avoid arbitration by simply alleging that the breach manifests a false promise without an intent to perform.

Indeed, this was the circumstance in *Prima Paint*. Prima Paint Corp. alleged that Flood & Conklin Mfg. Co. (F&C) breached a consulting agreement. 388 U.S. at 398. Prima Paint sought to avoid arbitration, alleging that F&C had fraudulently represented that it was solvent and would be able to perform its contractual obligations. *Id.* F&C did indeed enter into a bankruptcy reorganization proceeding one week after the parties had entered into the contract, but it emerged six months later. *Id.* at 398-399. Prima Paint waited nearly a year to claim fraud—when its first payment under the contract came due. *Id.* The alleged false promise

of an ability to perform the contract was intertwined with interpreting the particulars of the contract and assessing the parties' performance—issues properly subject to arbitration under the parties' valid, though arguably voidable, agreement.

The Court cited the Second Circuit's view expressed in the same case that, except where the parties otherwise intend, "arbitration clauses as a matter of federal law are 'separable' from the contracts in which they are embedded, ..." *Id.* at 402. The Court noted the contrasting view of the First Circuit that "the question of 'severability' is one of state law, ..." *Id.* at 402-403.

However, in its own analysis of §§ 3-4, the Court made no further reference to "separable" or "severability." The Court distinguished between fraud-in-the-inducement claims directed to the contract generally from those directed to the arbitration clause in particular. *Id.* at 403-404. The Court stated that in deciding a stay application under § 3, a federal court may consider only issues relating to the making and performance of the agreement to arbitrate. *Id.* at 404.

In *Prima Paint*, the Court did not consider whether an underlying contract with an embedded arbitration clause existed in the first place or was void *ab initio*. As discussed above, when such an issue is raised, to decide the existence of a valid embedded arbitration clause requires consideration of whether the underlying contract was created in compliance with state law applicable to "any contract" as required by § 2.

Dissenting in *Prima Paint*, Justice Black (joined by Douglas, J., Stewart, J.) expressed concern about the legal validity of contracts being adjudicated by arbitrators

"wholly unqualified to decide legal issues, and even if qualified to apply the law, not bound to do so." *Id.* at 407.

> [B]oth Congress and the framers of the Act were at great pains to emphasize that nonlawyers designated to adjust and arbitrate factual controversies arising out of valid contracts would not trespass upon the courts' prerogative to decide the legal question of whether any legal contract exists upon which to base an arbitration.

Id. at 408.

The fraud-in-the-inducement rule set forth in *Prima Paint* did not, as Justice Black may have feared, ride the FAA off a cliff. The dissent, however, provides a glimpse of the precipice should the holding be unreasonably extended to require arbitration in the absence of a legally valid underlying contract as determined by the courts.

Several members of the Court have at times expressed concern that the FAA should not be given an improper reach simply by extension from one case to the next. Concurring in *Allied-Bruce Terminix Cos. v. Dobson*, Justice O'Connor stated that:

> We have often said that the pre-emptive effect of a federal statute is fundamentally a question of congressional intent. [Citations.] Indeed, we have held that "'where . . . the field which Congress is said to have pre-empted' includes areas that have 'been traditionally occupied by the States,' congressional intent to supersede state laws must be 'clear and manifest.'" [Citation.] Yet, over the past decade, the Court has

> abandoned all pretense of ascertaining congressional intent with respect to the Federal Arbitration Act, building instead, case by case, an edifice of its own creation.

513 U.S. at 283. *See also id.* at 284-285 (Scalia, J. dissenting), 285-297 (Thomas, J., dissenting).

Discussing the scope of the FAA, the dissent of Justice Stevens in *Circuit City Stores v. Adams*, 532 U.S. 105 (2001), observed that:

> Times have changed. Judges in the 19th century disfavored private arbitration. The 1925 Act was intended to overcome that attitude, but a number of this Court's cases decided in the last several decades have pushed the pendulum far beyond a neutral attitude and endorsed a policy that strongly favors private arbitration. . . . There is little doubt that the Court's interpretation of the Act has given it a scope far beyond the expectations of the Congress that enacted it.

Id., at 131-132 (footnotes and citations omitted)(joined by Souter, J., Ginsburg, J., Breyer, J.).

If the FAA is now construed as a general federal license—and enforcement mechanism—for private parties to contract in violation of state law, the pendulum will have broken loose. Unhinged from law, the pendulum will become a hammer that wrecks havoc. Congress certainly never intended the FAA to be a mechanism for parties to circumvent by private agreement the effective exercise of general police powers by the states.

IV. Whether a matter is first referred to arbitration may turn on whether the challenge for unlawfulness is limited to a single, severable provision

There is a logical distinction between an illegality challenge directed to the underlying contract as a whole and one directed to a single, severable provision.

If the illegality voids the entire contract, there is no surviving arbitration clause—and no power could have been conferred on an arbitrator.

Conversely, illegality of a single provision, if severable from an otherwise valid contract that contains the arbitration clause, does not void the remaining lawful agreement. In that circumstance, the arbitration clause survives with the remainder of the contract; the parties' dispute is arbitrable; and even the illegality challenge to the single provision may be presented to the arbitrator—at least in the first instance.

Potentially, if the unlawfulness turns on the interpretation of a single provision of the contract, the arbitrator might construe that provision so as to avoid a conflict with state law.

The California courts have long applied this distinction. Determining that the illegality concerned the formation of the purported underlying contract, the California Supreme Court in *Loving & Evans v. Blick*, 33 Cal. 2d 603, 609-612 (1949), vacated a resulting arbitration award. Citing a state statute (Cal. Code Civ. Proc. § 1288(d)) that tracks the language of the FAA, 9 U.S.C. § 10(a)(4), the court held that:

> [T]he award must be vacated "where the arbitrators exceeded their powers, . . ." It

> seems clear that the power of the arbitrator to determine the rights of the parties is dependent upon the existence of a valid contract under which such rights might arise.

Id. at 609-610.

In *Moncharsh v. Heily & Blase*, 3 Cal. 4th 1 (1992), the California Supreme Court distinguished an unlawfulness challenge directed to a single, severable provision from a challenge to an underlying agreement as a whole:

> Both *Loving & Evans*, *supra*, 33 Cal. 2d 603, and *All Points Traders* [*v. Barrington Associates*], 211 Cal. App. 3d 723 [(1989)], permitted judicial review of an arbitrator's ruling where a party claimed the entire contract or transaction was illegal. By contrast, Moncharsh challenges but a single provision of the overall employment contract.

3 Cal. 4th at 32. The court determined that the arbitration clause survived in an otherwise valid employment contract and that enforceability of the single provision should have been submitted to the arbitrator.

If this Court determines that such a distinction is the correct approach under the FAA, it still might affirm. The Court might determine as a matter of federal law that the contractual provision challenged as usurious is so material that it affects the contract as a whole, or it might determine that the severability of a single unlawful provision should be determined according to state contract law. In this case, where the Florida Supreme Court asserted with respect to the arbitration clause that "there are no severable, or

salvageable, parts of a contract found illegal and void under Florida law" (894 So. 2d at 864), the result would then turn on this being a rule of general application, such that illegality of a single provision voids the entire contract.

V. Courts must decide illegality challenges, especially on post-arbitration review

Even if a party must first go to arbitration, a party is entitled to have its illegality challenge to a contract with an embedded arbitration clause decided finally—at some point—by a court rather than an arbitrator. *Cf. generally* Akhil Reed Amar, *A Neo-Federalist View of Article III: Separating the Two Tiers of Federal Jurisdiction*, 65 B.U. L. Rev. 205, 233-234, 246-255 (1985)(for two categories of cases in the first tier of Article III jurisdiction—"all" federal question cases and "all" admiralty cases—although the Constitution does not mandate *original* jurisdiction in the federal courts, a party must have a real opportunity to have the case resolved in a federal court at some point).

Such a guarantee is a necessary assurance against the misuse of arbitration to perpetrate unlawful conduct.

Petitioner Buckeye Check Cashing recognized as much in the answering brief it filed with the Florida Supreme Court. Petitioner cited the Ninth Circuit's first decision in *Theis Research, Inc. v. Brown & Bain*, arguing that:

> The simple answer to [respondents Cardegna and Reuter's] imaginative hypothetical concerning a contract to purchase and sell drugs that contained an arbitration provision, [br. citation], is that assuming there is no specific attack on the making of the arbitration agreement, the dispute would be directed to arbitration.

> Presumably, no arbitrator would enforce the underlying contract, but even if he or she did, a court would not enforce the arbitrator's award. *See, e.g., Theis Research, Inc. v. Brown & Bain*, 240 F.3d 795, 796 (9th Cir. 2001) ("TRI's assertions that the arbitration award was invalid because it was based on an illegal contract are properly resolved in the context of TRI's motion to vacate the award.").

Answer Br. at 17 n.2.

In its current decision, however, the Ninth Circuit has reversed course, holding (erroneously) that presenting the illegality challenge to an arbitrator bars courts from thereafter deciding the issue.

> Theis submitted to the arbitrator the issue whether B&B's alleged conflicts of interest rendered the Theis-B&B legal services agreement void *ab initio*. The arbitrator rendered a decision on this issue adverse to Theis. The district court thus did not err when it determined that Theis was barred from relitigating the same issue as part of its federal court malpractice claims.

Theis Research, Inc. v. Brown & Bain, 400 F.3d 659, 666 (9th Cir. 2005). The Ninth Circuit's holding must be disapproved and overruled.

California decisions have underscored the importance of judicial determination of an illegality challenge, particularly when raised in a proceeding to review an arbitration award. In *Loving & Evans*, the California Supreme Court explained that:

> [T]he rules which give finality to the arbitrator's determination of ordinary questions of fact or of law are inapplicable where the issue of illegality of the entire transaction is raised in a proceeding for the enforcement of the arbitrator's award.

33 Cal. 2d at 609. It made no difference that both sides had jointly submitted their dispute to arbitration "in line with" the underlying agreement. *Id.* at 604.[6]

The alternative to judicial determination is that courts would become the silent partners of those who would misuse arbitration to perpetrate unlawful conduct through illegal contracts. The FAA requires no such result. Instead, it prohibits such misuse by requiring in § 10 that courts vacate *ultra vires* awards—"where the arbitrators exceeded their powers . . .."

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[6] Even if, *arguendo*, despite the absence of authority in the FAA, arbitrators were granted limited authority to decide the existence of an agreement on which to base their own jurisdiction by (inapposite) analogy to the limited jurisdiction of federal courts to decide their own subject matter jurisdiction, judicial review of such decisions should then be *de novo*, *sua sponte*, and unwaivable.

CONCLUSION

Theis respectfully requests that the Court determine under the Federal Arbitration Act that if, under state law, a contract is unlawful as a whole and therefore void *ab initio*, then an arbitration clause embedded in such purported contract is without effect and confers no power on an arbitrator; that any arbitration award arising from such purported contract and clause is a nullity and must be vacated; and that courts—as opposed to arbitrators—shall decide such assertions of unlawfulness, regardless of the stage of proceedings.

Respectfully,

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